WRITTEN TESTIMONY OF
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INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE COMMITTEE ON THE BUDGET
ON THE
PROGRAM INTEGRITY CAP ADJUSTMENT IN THE FY 2008 IRS PROPOSED BUDGET

JULY 17, 2007

Good afternoon Chairman Spratt, Ranking Member Ryan and Members of the Committee on the Budget. My name is Linda Stiff and I am the Deputy Commissioner for Operations Support. I oversee, among other things, the IRS offices of Chief Financial Officer, Modernization and Information Technology Services, and Human Capital. I am pleased to be here this morning to discuss the program integrity cap adjustment and the use of the funds provided under this adjustment by the IRS.

First, however, I want to thank you Mr. Chairman and this Committee for your support for the IRS FY 2008 proposed Budget. As I will discuss later, this budget will allow us to go forward with several initiatives that will assist us from both a service and enforcement perspective.

This morning I would like to outline some of the accomplishments we have had with our balanced approach to tax administration, the challenges associated with increasing the levels of voluntary compliance, the importance of the program integrity cap adjustment to the success of our enforcement program, and the return we get on our enforcement investment.

A Balanced Approach to Services and Enforcement

In FY 2006, we continued making improvements in both our service and enforcement programs. This claim is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards “transforming itself into a modern institution that provides efficient and effective tax administration services to America’s taxpayers.”

We continue to see improvement in various taxpayer service programs. A survey commissioned by the Board in 2006 revealed taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as our Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This finding is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers for our customer service and usage levels in our telephone services, electronic filing, and IRS.gov access.

We have had similar success on the enforcement side. In assessing our work in FY 2006, the Oversight Board said, “As demonstrated by a variety of measures, the IRS’ performance on enforcement has improved considerably, and real progress has been achieved over the past six years.”

One of the most obvious measures of that progress is the increase in enforcement revenue, which has risen from $34 billion in FY 2002 to almost $49 billion in FY 2006, an increase of 43 percent.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns, almost 75 percent more than were conducted in FY 2001, reflecting a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.58 percent in FY 2001 to more than 0.97 percent in FY 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most evident in examinations of individuals with incomes over $1 million. The number of examinations in this category rose by approximately 78 percent compared to FY 2004, the first year the IRS began tracking audits of individuals with income over $1 million. The coverage rate has risen from 5 percent in FY 2004 to over 6 percent in FY 2006.

Growth in audit totals and coverage rates extends to other taxpayer categories. Preliminary estimates show that the IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over $10 million, examinations rose from 8,718 in FY 2001 to 10,578 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over $250 million, examinations have increased by over 29 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.

We have also been active in the tax-exempt community. Overall, examination closures for tax exempt organizations have risen from 5,342 in FY 2001 to 7,079 in FY 2006. In addition, we have an innovative program utilizing correspondence contacts to leverage our activities in the enforcement area. We have used it successfully in the hospital and executive compensation areas, and will be using it elsewhere.

While examinations in the tax-exempt community generally do not provide the tax collection “return on investment” that audits in other areas might, it is important that we keep a “cop on the beat” in order to prevent abuses in the exempt sector and an erosion of the tax base. Maintaining a strong enforcement presence in the tax-exempt sector is particularly important given the role that a small number of these entities have played in the past in accommodating abusive transactions entered into by taxable parties. In appropriate cases, this results in the collection of income or excise taxes -- and in the most egregious cases, revocation of exempt status.

Our ability to achieve these successes is dependent on having adequate resources to fund IRS service and enforcement functions. As I will discuss later in the testimony, the use of the program integrity cap adjustment is an important component in ensuring we have those resources, especially for enforcement.

The Tax Gap

Despite our success in increasing enforcement revenue, we still have a long way to go. In February 2006, we released updated estimates of the tax gap – the difference between the tax that is imposed by law and what is paid voluntarily and timely. That estimate revealed that the gross tax gap for Tax Year 2001 was $345 billion. This amount represents a voluntary compliance rate of 83.7 percent across all types of taxes and all types of taxpayers. When enforcement collections and other late payments were factored in, our estimate of the net tax gap was $290 billion.

Despite certain limitations, the most recent study incorporating results from a National Research Program (NRP) reporting compliance study of approximately 46,000 individual taxpayers for Tax Year 2001 represents the latest and best estimate of the tax gap. But, beyond the actual numbers, the study revealed a significant amount of information that has enabled us to address significant areas of noncompliance.

For example, the study revealed that underreporting – the failure to report one's full tax liability on a timely filed return – constitutes 82 percent of the tax gap. As with previous compliance studies, we also found that reporting compliance is strongest in the presence of substantial information reporting and withholding. While the net misreporting percentage for wages and salaries, on which there is withholding and substantial information reporting, is only 1.2 percent, amounts not subject to withholding or third-party information reporting (e.g., sole proprietor income and the "other income" line on Form 1040) are the least visible with a net misreporting percentage of over 50 percent.

The NRP also provided the IRS with a baseline for compliance trends and allowed the IRS to update audit selection formulas, meaning that we can target enforcement resources to those areas where we are most likely to find noncompliance. This improved focus not only improves our return on investment but avoids examinations of compliant taxpayers.

In an effort to attack the tax gap, the Department of the Treasury developed a "A Comprehensive Strategy for Reducing the Tax Gap." This plan was submitted to Congress in September 2006. It outlined a seven-prong approach to reducing the tax gap, including a plan to:

- Reduce the opportunities for evasion;
- Make a multi-year commitment to research;

- Continue improvements in information technology;
- Improve compliance activities;
- Enhance taxpayer service;
- Reform and simplify the tax law; and
- Coordinate with partners and stakeholders.

The Department of Treasury and the IRS are currently updating and providing additional information in support of the plan. That update should be submitted to Congress shortly.

It is important to note that while this plan presents a comprehensive strategy for increasing the rate of voluntary compliance, there are limits to how much we can increase that percentage without fundamentally changing the manner in which we interact with taxpayers. Achieving dramatic increases in the voluntary compliance rate would call for draconian measures that would likely be unacceptable to policymakers and taxpayers.

Program Integrity Cap Funding

Fully funding and protecting IRS resources for enforcement activities are key to improving voluntary compliance and, ultimately, reducing the tax gap. The *program integrity cap* establishes a budget framework for funding and ensuring IRS resources are dedicated to enforcement activities.

The President's FY 2006 Budget first applied a program integrity cap adjustment of $446 million for additional enforcement investments and inflationary costs necessary to maintain IRS's base enforcement levels. In the final Appropriations bill for that fiscal year, Congress included this program integrity adjustment and earmarked $6.447 billion of IRS base resources for tax enforcement and added an additional $446 million enforcement increase, for a total of $6.893 billion.

Much of the enforcement success in FY 2006 that I discussed earlier was the direct result of this increased funding provided by the program integrity cap adjustment.

The FY 2007 President's Budget again proposed a program integrity cap adjustment of $137 million for the inflationary costs to maintain IRS base enforcement programs funded in FY 2006. However, the FY 2007 Joint Resolution approved by Congress in February 2007 did not include the cap adjustment.

Once again in FY 2008 the President proposed a program integrity cap adjustment of $406 million for enforcement. Of that total, $115 million supports a portion of the cost to maintain current FY 2007 base enforcement levels (i.e. pay raise and other inflationary increases). The remaining $291 million supports IRS initiatives that focus on increasing voluntary compliance and reducing the tax gap.

FY 2008 Initiatives Funded by the Program Integrity Cap Adjustment

The IRS's FY 2008 enforcement initiatives are aimed at improving voluntary compliance by:

- Increasing front-line enforcement resources;
- Implementing legislative and regulatory changes; and
- Expanding the research program.

The following seven specific initiatives proposed in the FY 2008 Budget are aimed at improving compliance. When the new hires reach full potential in FY 2010, they will generate an estimated $699 million per year (all revenue estimates are FY 2010 estimates when the new hires reach their full potential). These initiatives provide:

- **$73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance.** This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating persons who have evaded taxes for possible criminal referral. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year.

- **$26.2 million for increasing compliance for large, multinational businesses.** This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 to 8.2 percent in FY 2008, and produce an estimated $74 million in additional annual enforcement revenue.

- **$28 million to expanded document matching at existing sites.**
  This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. The additional resources will increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010 and generate an estimated $208 million of enforcement revenue per year.

- **$23.5 million to establish a new document matching program at the Kansas City campus.** This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site is estimated to generate over $183 million in additional enforcement revenue per year.

- **$6.5 million to increase individual filing compliance.**
  This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and is estimated to produce $82 million of additional enforcement revenue per year.

- **$41 million for conducting research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance.** The data collected from these studies will enable the IRS to develop strategies to combat specific areas of noncompliance.

- **$23 million for information technology improvements to implement legislative proposals needed to improve compliance**. The FY 2008 President's Budget includes several legislative proposals that would provide the IRS with additional enforcement tools to improve compliance. It is estimated that these proposals could generate approximately $29 billion in revenue over the next ten years.

In addition, the budget includes two non-revenue raising enforcement initiatives, which are still important to a balanced enforcement program. These initiatives are:

- **$15 million to increase tax-exempt entity compliance.**
  This enforcement initiative will deter abuse by entities under the purview of the Tax-Exempt and Governmental Entities Division (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE enforcement contacts by 1,700 (six percent) and employee plan/exempt organization determinations closures by over 9,000 (eight percent) by FY 2010.

- **$10 million for increased criminal tax investigations.**
  This funding will help us aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which include an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity is aimed at fostering deterrence and enhancing voluntary compliance.

All nine of these initiatives support our strategic plan to reduce the tax gap.

Return on Investment (ROI)

I realize that it is important to this Committee, as it is to us, that these investments in additional enforcement resources demonstrate a justifiable return. Historically, IRS enforcement activities have yielded significant revenue.

ROI resulting from IRS enforcement programs ranges from $3 to $14 for every additional $1 dollar invested, depending on the type of enforcement activity. For example, labor-intensive activities such as the Collection Field Function have lower ROIs, and automated activities such as Automated Underreported have high ROIs. Overall, the ROI for the new initiatives discussed above is about 4 to 1, and the full benefit of revenue-producing initiatives is realized approximately three years after implementation when staff reaches its full performance level.

These ROI estimates are understated in that they reflect only direct enforcement revenue collected and do not include revenue protected through programs that deny fraudulent refunds such as Criminal Investigations. Nor does it include the impact that enhanced enforcement has on deterring noncompliance that helps to insure the continued payment of more than $2 trillion in taxes paid voluntarily each year. The indirect effect of increased IRS enforcement on improving voluntary compliance is not actually observed. However, research suggests it is at least three times as large as the direct impact on revenue.

Summary

Mr. Chairman, I would like to thank you and this Committee again for your support for the IRS FY 2008 Budget and the program integrity cap adjustment in the Budget Resolution. As the result of your demonstrated support of the IRS enforcement efforts, the House Appropriations Committee funded our entire request, including the cap adjustment, and the full House has since passed that appropriations bill.

Earlier I spoke of a balanced program – specifically the balance between service and enforcement and the balance within enforcement of targeting all areas of noncompliance. In many ways, our budget represents a balance. We will never audit our way out of the tax gap, but it is important that we have the resources to enforce the existing laws in ways that do not fundamentally change the manner in which we interact with taxpayers. The use of the program integrity cap adjustment provides certainty that the revenues appropriated for enforcement are used in enforcement.

Thank you and I will be happy to respond to any questions.